R5650-21

JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

A Two-Part Report: A and B

NO. 11B
March 20, 1992

IN THIS ISSUE:

Bears, Scandals And Reforms Pummel Japanese Financial Markets 1

Surveys Point To Reduced Japanese Plant And Equipment Spending 4

Pentagon Report Emphasizes Sound Alliances 5

Bears, Elephants, Tuna And Trade Highlight Conference Concerns 7

Tough Talk On Access To Japan's Semiconductor Market 9

Bears, Scandals And Reforms Pummel Japanese Financial Markets

With all the melodrama of a soap opera, Japanese financial markets continue to grapple with a string of mostly domestic cataclysmic events. Punished by stock-loss compensation scandals last year, Japan's securities houses now face a growing number of potentially expensive lawsuits by clients angry over a stock trading practice somewhat akin to check kiting. Also, sweeping changes in the finance sector could result from a Ministry of Finance package of legislative proposals approved by Prime Minister Kiichi Miyazawa's cabinet March 13. And further destabilizing the scene, the Tokyo Stock Exchange's Nikkei average dropped March 16 to below the 20,000 mark, raising the specter of panic selling by large investors.

Revelations that Japanese brokerages compensated favored clients for stock trading losses over several years to the tune of nearly ¥172 billion ($1.3 billion at ¥135=$1.00) have wrought more than MOF punishments (see *JEI Report* No. 40B, October 25, 1991). Court and arbitration cases now coming to light have revealed another questionable trading practice involving similarly large sums. When equity prices on Japan's stock markets were skyrocketing in the late 1980s, Japanese brokers dreamed up a scheme called *tobashi* or "flying," which allowed clients to realize capital gains while the securities dealers earned commissions at the same time. *Tobashi* takes advantage of the fact that companies "close" or tally their investment portfolios at different times.

divided over various aspects. Indeed, the government also is split over some questions. The Ministry of International Trade and Industry, for example, wants to retain control of nonbank financial institutions, while MOF is lobbying for a common set of regulations for all financial firms. If the Diet can shift its attention from the various influence-peddling scandals now occupying much of its time, major reforms are likely to be enacted; their exact form and content still remain to be worked out.

Jon Choy

Surveys Point To Reduced Japanese Plant And Equipment Spending

Car owners know that when their car engine begins acting up, they should seek a good mechanic. Similarly, plant and equipment spending, often described since late 1986 as the engine of Japan's economic expansion, is offering clues that suggest that the economy itself is under strain and in need of countermeasures. Since plant and equipment spending in the last few years has accounted for more than 20 percent of gross national product in Japan, significant overall growth is unlikely if investment spending declines.

In early March several government organizations and businesses released surveys of firms' plans for plant and equipment spending in the fiscal year that begins April 1. On balance, the reports suggest that the engine of growth is likely to sputter in the coming 12 months. Investment by manufacturers in new plant and equipment will fall substantially, while nonmanufacturing investment will be relatively flat, according to the surveys. That points to a modest drop overall in business investment in FY 1992 (see Table). Moreover, for the first time in five years the Bank of Japan's February quarterly short-term survey of business enterprises (*tankan*) indicated a decreased level of capital spending for the coming fiscal year. BOJ's survey of large firms showed that they expect to reduce investment spending 3.2 percent in FY 1992. This finding contrasts sharply with that for FY 1991, which, when it comes to an end March 31, is expected to show an 8 percent rise in capital spending from FY 1990's level.

Plant and Equipment Surveys for FY 1992

(percent change from year earlier)

	Number of Firms Surveyed	Projected Change in Capital Spending		
		Total	Manufacturing	Nonmanufacturing
Industrial Bank of Japan, Ltd.	3,327	-4.0%	-10.7%	-0.9%
Nihon Keizai Shimbun	1,564	-4.9	-11.8	1.3
Japan Development Bank	2,145	-0.8	-6.4	3.2
Bank of Japan (*tankan*)*	689	-3.2	-8.2	0.2

*Large firms only.

The new *tankan* also reported the latest business conditions diffusion index for large manufacturing firms, a widely cited indicator of corporate sentiment. For the first time since 1987 the index — calculated as the excess of positive over negative responses — moved into negative territory, measuring a minus 12 percent versus a positive 13 percent three months earlier (see *JEI Report* No. 47B, December 20, 1991). Inasmuch as previous drops below zero have occurred during what passes for recessions in Japan, the latest reading provides additional evidence that Japan is in the midst of an economic downturn, even if official acknowledgement has not yet been forthcoming.

Some evidence suggests that plant and equipment spending in the coming fiscal year could be worse than the reports portend. Most surveys concentrate on large firms, yet investment by small companies is significant in the aggregate. BOJ's *tankan* survey of small firms showed that they plan to cut capital spending by an extraordinary 23.5 percent in FY 1992. The finding hints that the lower interest rates of recent months have not been sufficient to overcome pessimistic sentiment among small companies, which rely heavily on credit markets to finance fixed investment.

An Economic Planning Agency report issued in early March provides supporting, albeit somewhat different, evidence concerning the slowdown in plant and equipment outlays. Based on equipment orders already placed and taking into account the six- to nine-month lead time between when orders are placed and machinery is delivered, EPA estimates that capital spending will be 2.7 percent lower in the first six months of FY 1992 than a year earlier. Although the estimates by EPA and others are based on investment plans without any adjustment for price increases, capital goods inflation in recent years has been negligible in Japan, suggesting that real capital spending will be approximately the same as the nominal figure.

The forecasts of reduced overall business investment in the upcoming fiscal year imply a still high level of Japanese plant and equipment spending since increases in annual outlays have run in the double digits in recent years. However, the economy will not get a short-term boost from capital investment unless spending increases from the current lofty levels. Events that have occurred since the surveys were taken in late February and early March suggest that the small decreases in investment spending now anticipated could become much sharper as the year progresses. The *tankan* result concerning business sentiment, which was worse than expected, plus the fall of the Nikkei average to a five-year low March 16 (see preceding article) indicate that both the demand and the supply of funds in capital markets will be restricted in coming months.

Not surprisingly, business and political leaders in Japan have called for countermeasures in the form of lower interest rates. The Ministry of Finance was successful in indirectly talking long-term credit banks out of raising the long-term prime rate for March. In addition, the call to the master mechanic — Yasushi Mieno, governor of the Bank of Japan — has gone out in the form of a plea to lower the central bank's discount rate by as much as a full percentage point. Mr. Mieno, accused by some analysts of having thrown a monkey wrench into Japan's economic expansion in the form of continued high interest rates, so far has shown no sign he will drop the rate below its current level of 4.5 percent. That rate, set December 30, is half a percentage point lower than the one that had been in effect since November 14 (see *JEI Report* No. 1B, January 10, 1992). As noted above, small firms, which are most dependent on capital markets, have not responded positively to the 4.5 percent key rate. To ensure peak performance of the Japanese economy, a major tune-up may be in order in the form of a package of more extensive monetary actions as well as fiscal measures.

Douglas Ostrom

Pentagon Report Emphasizes Sound Alliances

The U.S.-Japan Mutual Security Treaty will continue to be an important element in Washington's post-Cold War defense strategy, according to the Department of Defense's 1992 report to the president and Congress. While acknowledging that the threat to global peace caused by the "expansionist ambitions of the Soviet Union" has disappeared with the demise of the former communist power, the 154-page defense document emphasized that, as demonstrated by the Persian Gulf War, potential regional conflicts will challenge America's national security interests. Moreover, the proliferation of weapons of mass destruction as well as the global diffusion of military and dual-use technologies will enable regional adversaries to acquire weapons capabilities that in the past were limited to the superpowers, the Pentagon maintained in the report released in late February. For